Exit and Voice Preferences of Group-Members as a Result of Cooperative Growth

By

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Abstract

The enlargement of the European-Union and the resulting open market for commodities in general and agricultural commodities in particular, which is stretching over 27 countries, accompanied by dismantling of trade barriers following the recent WTO negotiations, opens a vast opportunity for the foods retail sector. Food retailers can now more than ever source for their suppliers not only all over the European market zone, but practically all over the globe, securing best product quality for the best conditions. Under these conditions and the asymmetric distribution of bargaining power between the producers' and retailers' sectors, the producers are now facing a price pressure in scales that have never existed before. Since their very beginning, cooperatives have been established in order to encounter unbalanced bargaining power and help small structured producers to a better position confronting purchasers of agricultural products. However, whilst retail firms possess the ability to grow and expand almost unlimitedly, cooperatives retain internal growth barriers which origin in their nature as voluntary associations of individuals. The so called dual nature of cooperatives determines their entity as a social group in addition to their being an economical enterprise. Only a relatively small organisation can secure a group

consciousness of its members. The group characteristic of the organisation changes as the group grows. This work focuses on the changes in participation preferences of the members in a growing group. Under the premise of rationality and expanding the concept of M. Olson about the logic of collective action, we formulate the dependency between the value of membership for the individual members and the size of the group. We then apply contemporary insights about the complementary character of exit and voice strategies and construct a model for the member's rational choice between these options and its dependency on the group's stage of growth. The results will demonstrate that, under the premise of rationality, group members' tendency to interact rather than to exit the organisation would change while the group becomes larger. The conflict between the interest of the organisation to expand the number of its members in order to encounter market power, and that of the individual members to keep the group small, creates varying challenges for the organisation's management. This insight is crucial for the understanding of the character of cooperatives in general, their limitations in serving as an instrument of encountering power in case of imperfect competition, and the necessity of adapting management techniques to the size of the group in particular.

Introduction

Modern food retail chains demonstrate an ever growing tendency to perform internationally at the distribution as well as at the acquisition levels. The reduction of market imperfections such as trade barriers and of transportation costs for goods, persons, services and information, deliberates purchasers from geographical bounds and enables them to enjoy many advantages of market globalisation. The constant supply of fruits for instance, has become so obvious to European consumers, that many of them can't tell anymore when the strawberry season actually is. German consumers are not even surprised anymore to find strawberries on the supermarket shelves in the middle of February. Trade between different clime zones and even hemispheres makes this possible. But not only is the luxury of summer fruits in the middle of the winter made possible by trans-regional supply systems. Also a higher level of supply security of basic nutrition is guaranteed thanks to geographical distribution of risks and the quick availability of alternative sources of commodities in case of a regional supply crisis.

Growing buying power in emerging markets encourages retailers, just like producers, to enter these regions and cut a slice of the growing prosperity in these lands. However,

the geographic expansion of the operation regions makes it possible – but at the same time necessary – for retailers to integrate variable sources from variable locations to secure their supplies. Three crucial aspects are to be accounted for in the context of international food retail: the first is the quantity, the second is the quality and the third is the price of the delivered products. Large quantities are the obvious result of expanding market activities. In order to operate internationally and rotate large stocks, highly developed logistics are necessary. Modern retailer chains are operating large-scale logistic centres, accumulating large deliveries and distributing over long distances to the chain-stores. For this purpose retailers are increasingly seeking for and depending on suppliers who can provide them with large quantities of products. Moreover, large scale logistics make it difficult to control the quality of the products delivered. The main quality control and assurance by big chains does not take place along the logistic chain anymore nor at the time of purchase, but is based on customer response and complaint-management. Consequent quality problems are often becoming known to the retailer when it is already too late. Grave damages to retailers' reputation and customer trust are a risk faced by retailers and which must be minimised. In case of repeating customer complaints over a certain product, the retailer turns to the supplier, and in case no improvement can be achieved, an alternative supplier is being sourced for. Securing high – and not less important – constant quality standards is increasingly a task, a commitment, a responsibility and an interest of the supplier. The flexibility and variability that are retained to purchasers through the possibilities opened by trans-regional and international sourcing also make it easier for them to seek for the best opportunities on the markets. Suppliers are therefore forced to secure quantity and quality of deliveries and at the same time are exposed to high bargaining pressure of the purchasers.

As production location loses its significance to high quality standardisation, low prices and aggregated supply of large quantities, agricultural commodities producers are forced to comply to these new demands, and do not enjoy bargaining power resulting from regional dependency of purchasers on their supply anymore. In order to be able to keep up with the new demands and compete with (sometimes geographically distant) alternative suppliers of similar products, growers are nowadays forced to find solutions for delivering large aggregated quantities of high standard quality products at competitive prices. Concentrating supply structures seems to be unavoidable under these conditions. In spite of increasing industrialisation of agricultural production, individual farmers are still far away from being able to satisfy the demands of food markets. Now, like in the past, they need to choose between either selling their product to someone else or create their own marketing institutions. Due to the danger of exploitation by large scale handlers, there seems to be no other alternative for the individual grower than to join forces and cooperate with other growers. Co-operative enterprises are perhaps the most intuitive answer for growers facing changing modern food markets.

The Role of Co-operatives in Agricultural and Food Markets

The production of agricultural products is inherently bound to land. In the case animal husbandry for instance, it is the need to provide the stock with roughage, a factor which is hardly tradable and hence needs to be produced on the own farm, which determinates a certain spatial distribution of agricultural production. Agricultural commodities are especially characterised as bulky and perishable, which restricts their geographical mobility and implies high transportation costs, creating spatial markets. Both processors and producers are highly specialised. A given farm product can usually not be substituted by other inputs, nor can it substitute another one. High specialisation on the

production as well as on the processing level and high sunk costs implying high exit barriers for farmers and an inelastic supply (ROGERS and SEXTON, 1994), bound farmers to handlers and limit their choice of purchasers for their products. In case of losing access to a certain first-handler, farmers are forced to seek for alternative – sometimes distant – purchasers, which reduce the value of the product. These characteristics lead to spatial markets and buyer market power at the first-handler level.

In order to countervail oligopsony power in agricultural markets, agricultural producers incorporate into co-operatives, facilitating the marketing and/or processing of their product, in which they can also influence the price they receive. Private agricultural product traders are thus forced to adapt their prices to the competition delivered by co-operatives. Hence, the existence of co-operatives in mixed markets influence the price level in the whole market, and by that, prevents it from falling too low. The notion that a co-operative may have a salutary effect on its rivals' pricing behaviour is known as the "yardstick of competition" (SEXTON, 1986b, 1990) hypothesis. However, it immediately becomes obvious, that this market-regulation effect is an open resource, as not only members of the co-operative, but also the rest of producers on the market, benefit from this regulation affect. Moreover, as private actors set their trade conditions to compete with a present co-operative, opportunity costs are being created also for co-operative members.

Growth Limitations of Co-operative Organisations

The co-operative is by its nature a hybrid organisation. Except for being an economical enterprise it also functions as a group in the social and socio-psychological sense. A crucial prerequisite for its durable stability as an organisation, even for its mere existence, is the commitment of its members (FULTON, 1999). As demonstrated by Fulton (1999) co-operative ideology is a significant driving force for the formation of co-operatives and has a significant impact on the members' behaviour as well as on the co-operative performance. Owning and controlling the organisation is the differentiated product that makes at least some members prefer making business with it, rather than with a competing IOF. However, facing growing dynamic in modern agricultural and food markets, co-operative ideology is evidently breaking down (FULTON, 1999). At the turn of the century the relation of the members with their co-operative was strongly based on a social rather than commercial, balanced rather than hierarchic, cooperative rather than competitive and membership- rather than business-oriented character. Modern co-operatives however, seem to feature an opposite image, characterised by an isolated – market typical – interdependency, a hierarchic rather than democratic power distribution, conflicting rather than harmonic attitude and a commercial business rather than personal member orientation (ZIEGER, 2008). These developments loosening the cohesion between the members and between them and their co-operatives are undoubtedly impelled by – among changes in the social, cultural and economical environments of the co-operative existence – the growing structure of the memberships. However, as this work is attempting to demonstrate, the relationship between the group's structure and the behaviour of its members is bilateral and interdependent. As the group grows and the commitment of its members erodes, their behaviour is changing accordingly. With a weakening cohesion, the members' tendency to abandon the organisations for the sake of realising other opportunities is growing dominant. Analogue to sinking birth- and growing death-rates in natural populations (LASOWSKI and KÜHL, 2006), the changing members' "traffic" into and out of co-operatives as a result of their size cause a limitation to the growth capabilities of co-operative groups. This "natural" property might be a handicap for co-operatives facing the demands of modern agricultural and food markets.

The Membership-Value Model

The following model is designed to delineate a co-operative enterprise purchasing a single homogenous product from its members, adding to its value and marketing it. The co-operative is assumed to be acting as price taker on the market. The costs of the enterprise's activity is assumed to be a convex function, and due to a set price received on the market, the earnings a concave function of the processed quantity. Co-operative members are assumed to judge the desirability of membership on the basis of the incumbent firm's prevailing price, whereas members are price takers in respect to dealing with the co-operative as well as with a competing purchaser (SEXTON, 1986a). Acting according to individual rationality, each agent would remain member in the co-operative group as long as she receives at least as much as from acting unilaterally i.e. marketing the product otherwise (SEXTON, 1986b, STAATZ, 1987, ZEULI and BENTANCOR, 2005).

Consider a group of G members who join forces to produce $M(G)$ units of a certain co-operative product which they sell on the market for a certain price P [1]. The total costs of producing the co-operative product feature the same dependency on the quantity as non co-operative products. When the demand for production capacity exceeds a critical level, the production cost of each additional unit will no longer decrease, but rather increase over-proportionally. The progression of the average production costs curve $K = f(M)$ is therefore assumed to feature the classical U-Form (OLSON, 1965 p. 21). The co-operative costs K and the revenues $W = PM$ are distributed between the members according to their relative portion on the total production quantity of the group, so that $K_i = (m_i/M) \cdot K$ and $W_i = (m_i/M) \cdot PM$, whereas m_i represents the portion of member i in the total production M of the co-operative and K_i and W_i are respectively the member's shares in the resulting costs and revenues. In order that the members take part in the co-operative, there must be a positive utility for each of them (OLSON, 1965, SEXTON, 1986a, ZEULI and BENTANCOR, 2005). $\Pi_i = W_i - K_i \geq 0$ is therefore the gross value of membership for each member *i*. Moreover, each of the members could market the same product alternatively, either alone or by utilising the services of another source, having alternative costs Ka_i and achieve alternative profits Πa_i (SEXTON, 1986a). The options for profits which the members face are hence,

$$\Pi_i = W_i - K_i = m_i P - (m_i/M)K = m_i\left(P - K/M\right)$$

or

$$\Pi a_i = m_i P - Ka_i .$$

The quantity m_i that the member would alternatively market is assumed to be the same as his or her share on the cooperative production, and they would sell their product to the same market price. In order that they take part in the co-operative, the profit that they achieve by the membership[2] must be higher than that, which they could achieve by their own. The condition for membership is therefore $\Pi_i - \Pi a_i = m_i(P - K/M) - m_i P + Ka_i \geq 0$. The difference on the left side of the

[1] The market is assumed to be large enough, so that the group is considered as price-taker i.e. the quantity produced does not have an influence on the market-price of its product.

[2] No attempt is done here to quantify the portion of individual non economical motivations' fulfilment in the composition of the total utility the member receives from membership. It is enough to measure the cost, for which the member would exit the group, as an indicator for his or her total utility.

equation we mark as Ψ_i the net value of membership and its positive value is a necessary condition for membership in the group:

$$\Psi_i = Ka_i - (m_i / M)\, K \geq 0$$

Or:

$$Ka_i \geq \frac{m_i}{M} K$$

Thus, it becomes obvious that the member's share in the cooperative production costs must be smaller than the costs which would be caused by the alternative marketing. Assume that the production quantity of the co-operative must be expanded by a unit of quantity for each entrance of an additional member to the group. When the convex cost function begins increasing over $[0, M(G)]$, the condition for membership cannot be guaranteed. We should then expect the net value of membership to become null or negative at some stage for any member[3].

The Complementary Strategic Options: Exit and Voice

Consider a co-operative of G members is considering the option to accept an additional member. One of the group members disagrees. The group's size has reached its limit for her; the membership still yields a positive value for the member at this point, but any further growth would cause the exceeding of her price-threshold. Since the member's alternative production costs are about to be exceeded by her share in the cooperative production costs, she now needs to make her strategic choice between "exit" and "voice" (HIRSCHMAN, 1974). The option to exit means that the member could leave the group and produce her product independently. As a result of this choice, the group loses one member, so that the number of members in the group drops shortly to *G-1*. After the member's exit, the group would accept the new member and even up its size back to *G*. At that point, the group would reach its original size again, which would have justified for the exiting member to remain in the group. Since there is a positive probability of influencing the group's decision and preventing the new member's entrance, voice would be the rational choice. Moreover, the option to exit is not eliminated by the option to protest. As Zhu, Hendrickse and Krug demonstrated (ZHU, HENDRICKSE and KRUG, 2006), exit not only remains as a last resort, but underpins member's voice making the threat more credible, and can therefore also be used as an instrument of pressure by the protesting member. By choosing the option "voice", the member could raise a protest and by that, try to prevent the further negative development of the group. Among the loyalty of the member to the group and the uncertainty, considering the further negative development of the organisation after her – perhaps irreversible – exit, one of the main determinants for the choice of "voice" is how high the member estimates the chances to influence and amend the organisation.

In case the member chooses the option "voice" and raises her protest, there is a chance for an effective protest, and that the entrance of the new member into the group can be prevented. This chance is depending on the total number of group members and on the relative share of the protesting member in the total production. The size of the group determines the following factors:

[3] We assume a heterogenic group. Otherwise the membership would lose its value for the whole group at one point.

- The probability of determining the outcome of a democratic election becomes lower the bigger the group grows[4] (TAYLOR and YILDIRIM, 2005, BORCK, 2002).
- The costs of voice increase since there is a larger number of persons that need to be reached (DOWNS, 1957) and
- The probability to influence the group decreases with increasing anonymity in the group and decreasing interaction intensity within it (BUTLER, 1988).

Therefore, the bigger the group the smaller is the chance to influence it. Indeed, the member's share on the total co-operative production is another determinant for his or her influence on the group. The bigger the relative share m_i of the objecting member *i* in the total co-operative production, the greater is the influence she has on the group. However, the relative share of the individual member on the total production also decreases as the group grows. In case the strategy of voice is successful after all, the member succeeds to prevent more new entrances, and holds up the growth of the group for a longer period before she exits[5]. In that case, the protesting member has her aim achieved, she remains a member in the group and the group maintains its size G. If the protest is not effective, the new member is being accepted and the number of members in the group shortly rises to $G+1$. The unsuccessfully protesting member exits at this point and the number of members drops back to G.

The member that we are observing is facing two alternatives with three possible outcomes. The first alternative is to leave the group and acquire his or her share on production or service from another source and for a price known to this member. The outcome of the choice to exit is certain since the member is either aware of an actual alternative source, or has already included the risk discount factor into the calculation of "his" or "her" alternative costs Ka_i. The choice of voice has two possible outcomes; either the member is able to influence the rest of the group and prevent the entrance of the new member, in which case the group maintains its initial size it had on the beginning of the day, or the new member is being accepted. However, in case the loud protest is not effective, and the group decides to accept the new member in spite of it, the protesting member still maintains his or her option to exit the group. In this case, our observed member whose share on the common production costs has been exceeded would take the rational choice and exit the group for the sake of her – now lower – alternative production costs. Again, the total number of members in the group remains the same as at the beginning of the day.

The situation in which a co-operative group is about to decide whether to accept a new member, an option to which a member in the group objects, is a strategic decision situation for the member. The procession and consequences of that decision for the member and for the group will be considered in the next section.

[4] Typical to cooperatives is the principle of "one person – one vote".

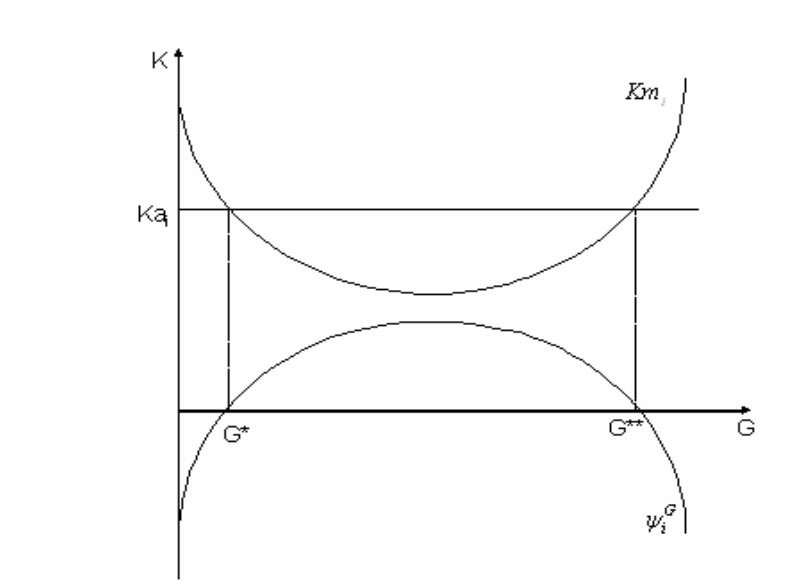
[5] *P(w)* is also depending on the form of government; a cooperative is assumed to have a free entrance, whereas in a club, the members have more influence on the process of new members' selection and acceptance

The Model

Consider a co-operative member i who draws a net value ψ_i^G from membership, attained by the difference between her alternative costs for offering her product on the market Ka_i, and her relative share in the co-operative costs Km_i. As the total co-operative costs is a convex function of the number of members in the group G, this difference is a concave, continuous and twice differentiable function over G such that $\partial^2\psi_i^G / \partial G^2 < 0$ for all G, and there exists a range $[G_i^*, G_i^{**}]$ of the number of co-operative members so that

$$\begin{cases} \psi_i^G > 0, & G_i^* \le G \le G_i^{**} \\ \psi_i^G < 0, & otherwise \end{cases}$$

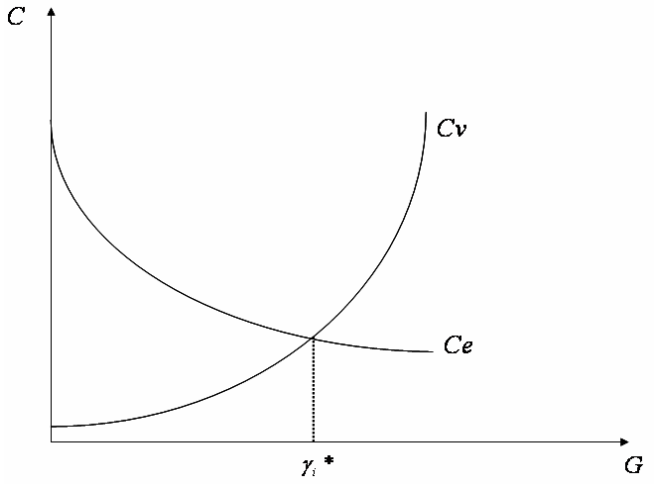
Figure 1 gives the graphical representation of the relations of these functions.



We now observe the situation in which the group has reached the size G^{**} for which $\psi_i^{G=G^{**}} > 0$. For $G^{**}+1$ the net value of membership would be negative for the observed member i. The observed member has now the choice between three options: exit inducing costs Ce, voice inducing costs Cv, acquiesce, i.e. accepting the entrance of a new member and taking on a negative value of ψ_i^G which we mark as the cost Ca. In addition to the direct costs of reorientation and adjustment, the costs of exit include also the risk involved and the loss of intrinsic surplus caused by breaking the member's commitment (or loyalty) to the group and switching to another business partner. Since the commitment to the group is declining as the group grows and anonymity of the individual member rises, Ce is considered as a positive and declining function of G. On the other hand as the group grows, the costs involved in pivoting its decision[6] are rising, so that Cv is a constant rising function of G. Therefore there is a critical size $\gamma_i *$ of the group, for which $Cv > Ce$ when $G > \gamma_i *$, and $Cv < Ce$ when $G < \gamma_i *$. The advantage of voice over exit and vice versa, pivots as a function of group-size.

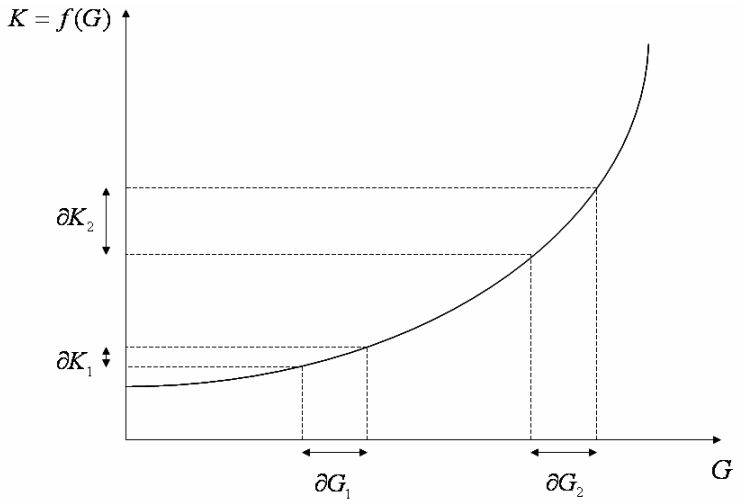
[6] We define *Cv* as the cost for the member to secure that the group decides to refuse the entrance of an additional member to the group.

Figure 2 gives the relation between the costs of exit and voice as a function of G



At this stage we need to take a closer look at the cost of acquiesce Ca. As defined before, the total cost function of the co-operative enterprise features a convex U-form. We shall now concentrate on the right half of the curve, the range in which the costs are rising as a function of the produced quantity, and therefore as function of the number of members in the group. Let ∂G_j represent an addition of one member to the group at any point *j* along the cost function curve. It is easy to see that the resulting rise in the total production costs ∂K_j of the group is growing with the number of group-members *j*. For a graphical presentation refer to figure 3.

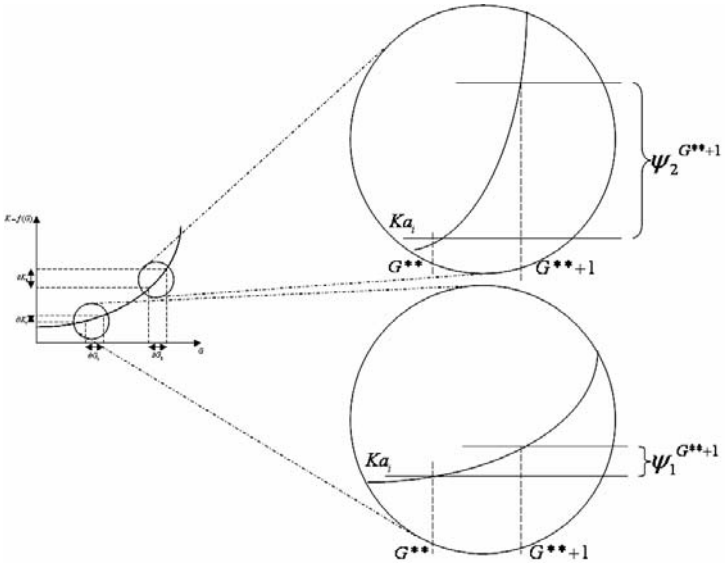
Figure 3 presents the range in which the convex cost function rises



Each group member has a point on this curve, at which it accedes "his" or "her" alternative cost Ka_i which can be located anywhere between the points G^{**} and $G^{**}+1$. The costs of acquiesce is the actual negative utility from membership when the number of the members in the group has reached $G^{**}+1$. This negative utility can take any value in the range $[0, \psi^{G^{**}+1} - \psi^{G^{**}}]$. This range however, is a growing function of G due to the convexity of the total cost function. As graphically demonstrated in figure 4, the maximal value $\psi^{G^{**}+1} - \psi^{G^{**}}$ that the cost of acquiesce can take is a rising function of the number of members G. Inversely phrased, when the group becomes bigger Ca can get much higher than it could if the group was still small. The payoff from acquiesce is,

by definition of the point G^{**}, negative. However, the absolute value that this loss can take is also a function of G.

Figure 4 demonstrates the different values of possible negative utilities from membership as am effect of the number of group members



Results

For the first stage of the decision model we need to differentiate between two possible situations: first, when (1) $G > \gamma_i^* \Rightarrow Cv > Ce$, and second, when (2) $G < \gamma_i^* \Rightarrow Cv < Ce$. If situation (1) is the case, the member chooses the option of exit and lives the group. The resulting payoff for the member is then $-Ce$. In case situation (2) occurs, the rational choice of the member would be the option voice, in which case the member's payoff is $\psi_i^{G^{**}} - Cv$. This payoff is either positive or negative, whereas, as shown in figure 2, the bigger the group the higher becomes the probability that this payoff is negative, and even worse than the payoff of exit. For the second stage we need to compare the first two options, exit or voice, with the option to acquiesce. The payoff from acquiesce is, by definition of the point G^{**}, negative. However, the absolute value that this loss can take is also a function of G. Although we can not formulate a rule for the advantage of one option over the other, since these are determined by the concrete situation and by random factors, we can claim a rule about the effect of membership size on the advantage of any particular choice over the other. The larger the group of co-operative members, the higher is their rational tendency to exit and leave the group rather than to accept its development or to raise protest and try to influence it.

Summary and Conclusion

The co-operative is by its nature, not only a form of enterprise governance, but also a group of individuals who join their forces in order to fulfill a common economical purpose. By serving a common cause, the members of the group also fulfill a series of personal – non economical – needs. The accumulation of these needs is the glue holding co-operative organisations together, usually recognised as members' commitment. Agricultural and food markets are undergoing a constant change, as borders break down, trade barriers fall and multinational market actors are entering market they have traditionally ignored. Modern retail markets are increasingly characterised by highly concentrated structures. Agricultural markets feature increasing industrialisation and a liberalised trade. These processes set major structural challenges for co-operatives as

they are forced to respond by merging and finding new ways of raising capital. In order to keep up with competition and to maintain their bargaining power in these markets, co-operative market-actors are forced to expand their structures to ever growing dimensions. While serving the cause of maintaining competitiveness, increasing the size of the group has a negative influence on the group-perception of the individual member. The glue holding these groups together is loosening as a direct result of organisational growth.

This work is an attempt to simplify the issue of group cohesion into the frame of rationality. The expression of membership-incentives is satisfied merely through the costs of exit, increasing anonymity and decreasing influence of the individual member on the group is expressed by the costs of voice, and all these are analysed in the face of opportunity costs, expressed by the conditions offered by a competitor. These three elements are sufficient for demonstrating, that the tendency of members to leave a co-operative group is increasing as the group grows. This recognition is crucial first of all for the mere understanding of group-dynamics in general and of the co-operative group in particular. Moreover, it is essential for understanding the difficulties and limitations co-operatives face concerning their ability to keep up with structural challenges created by modern food and agricultural markets. And finally, this recognition is crucial for the correct conception of imperatives for the design and adaptation of management tactics and strategies for growing co-operative groups.

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